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**Memorandum for:**

The Record

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State Dept. review completed

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This memorandum was prepared [redacted]

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[redacted] to address the potential economic and political problems associated with the falling British pound. It also addresses the issues Prime Minister Thatcher may raise during her visit to Washington.

EUR M 85-10028

15 February 1985

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Central Intelligence Agency



## DIRECTORATE OF INTELLIGENCE

15 February 1985

Thatcher's Troubles with the Falling Pound

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Summary

The falling pound has placed Prime Minister Thatcher in a difficult political and economic situation. The Labor Party is charging economic mismanagement and the cost of dollar-denominated defense programs is rising. Moreover, London's decision to support the pound by raising interest rates threatens to retard economic growth. To some extent, Thatcher has tried to lay the blame for the pound's weakness on external factors beyond her control. She has publicly maintained, for instance, that part of the pound's problem is due to the "unprecedented" value of the dollar. We believe that when Mrs. Thatcher meets with the President on 20 February, therefore, she will seek assurances of US action to contain the dollar's rise and may request supplemental financial assistance for the purchase of the US-built Trident missiles.

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The recent weakness in the pound is not a new phenomenon. Over the last four years the pound has been falling sharply against trading partner currencies -- even after adjustment for inflation differentials. We believe this decline mainly represents a correction of sterling's previous overvaluation, although almost one-third of the decline reflects the unusual strength of the dollar. Sterling's latest plunge -- which began in mid-December--was primarily triggered by fears of a further drop in oil prices.

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This memorandum was prepared by [redacted]

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[redacted] in the Office of European Analysis. Questions can be directed to the Chief, Western Europe Division [redacted]

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While the pound no longer appears to be overvalued, we cannot rule out further depreciation. Should oil prices fall again--which many oil experts expect--the pound is likely to continue its slide. This would further improve British industrial competitiveness in the longer term, but if accompanied by continuing high interest rates it would reduce real economic growth prospects. A prolonged pound crisis, therefore, might threaten the entire "Thatcher Revolution" by convincing voters who supported her in 1979 and 1983 that the country is on the same "stop - go" treadmill that the Tories promised to stop. [redacted]

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#### Background: Economic Conditions and Policy

Prime Minister Thatcher's effort to revitalize the British economy has achieved some important successes (see Table 1). Economic recovery has been under way for about three years -- most notably in the business sector, where profits and productivity have made strong gains. The annual rate of inflation has slowed dramatically to less than 5 percent, bringing it into line with Britain's trading partners. Thatcher also has made significant progress in "privatizing" nationalized industries, restraining union power, and restructuring the inefficient steel sector. [redacted]

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Nonetheless, some problem areas remain. Economic recovery has not been fast enough to arrest unemployment, which is now over 13 percent and still rising. Moreover, the huge current account surplus recorded in 1981 had disappeared by last year due largely to a sharp deterioration in the manufacturing trade balance. Thatcher also has made less progress than she expected in reducing the budget deficit and slowing monetary growth. [redacted]

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The Thatcher government's 1985/86 Public Expenditure White Paper continues to stress lower inflation and reduced public borrowing as keys to sustained economic growth. It calls for a 1.3-percent decrease in real spending in the fiscal year beginning in April, a freeze in real defense outlays, a 6.6-percent cut in capital spending, and only a 1-percent hike in social expenditures. To boost consumer spending, a \$1.5-2.0 billion reduction in income taxes has been promised. [redacted]

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Recent economic forecasts for the United Kingdom -- done in late 1984, before the latest dip in the pound -- generally predict some pickup in economic activity this year. According to the forecasts, real GNP growth should surpass 3.0 percent in 1985, compared with growth last year of only 2.4 percent, assuming the miner's strike ends in the spring and the government carries through with planned tax reductions in March. Last year the reduction in coal output and the strike's negative impact on other sectors probably shaved close to 1 percentage point from GDP growth, according to British government estimates. Most forecasters -- other than the British government -- anticipate a slight pickup in inflation due to increased wage demands, and a continued rise in unemployment during 1985. Most also expect the current account to be near balance in 1985 as energy exports recover, imports of oil fall back to normal levels, and non-oil imports rise with an increase in disposable income. [redacted]

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### The Ups and Downs of the Pound

Like other Western currencies, the pound has experienced large oscillations during the last decade, abetted in part by the United Kingdom's shift from being a large net oil importer to being a significant net oil exporter. After a period of relative stability in the mid-1970s, the pound began to appreciate sharply at the end of 1978 as domestic oil production rose (see Figure 1). By first half 1981, we calculate that -- on a trade-weighted and price-adjusted basis -- sterling had risen 43 percent above its 1975-77 average.

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During 1981, however, the pound reversed course, and by the end of January 1985 its trade-weighted price-adjusted value was within 5 percent of the 1975-77 average. Most of the decline has been a correction from the previous overvaluation -- which seriously eroded British international competitiveness and led to an \$18-billion deterioration in the non-oil current account balance over the past three years. The general strength of the dollar also has placed downward pressure on the pound. If the dollar is removed from our exchange rate calculations, the trade-weighted price-adjusted pound was 16 percent above its 1975-77 average as of 31 January. In other words, the rise of the dollar accounts for almost one-third of the fall in the pound since early 1981.

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Sterling's latest episode of weakness began in mid-December. After seeming to stabilize at about \$1.20, the pound plunged 9 percent in a month, reaching \$1.11 on 14 January. This decline reflected mainly pound weakness rather than dollar strength because sterling fell almost as much against other major currencies. The pound weakened primarily because of uncertainty over future oil prices and growing questions about London's resolve in fighting inflation. The coal strike also has been a contributing factor -- we estimate that reduced coal output and increased oil imports is costing Britain \$5 billion at an annual rate in forgone foreign exchange earnings.

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### Exchange Rate Policy

In line with her overall free-market philosophy, Thatcher's basic exchange rate policy has been to let the exchange markets determine the value of the pound. She has said, however, that the pound should remain above parity with the dollar, and government spokesmen have made clear that London will act if the pound drops too quickly. On at least two occasions -- October 1981 and July 1984 -- London boosted interest rates sharply to halt a run on the pound. In both cases most interest rates came back down rather quickly, returning to pre-crisis levels within about six months.

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To arrest further depreciation of the pound, the Bank of England raised the commercial bank lending rate by 1.5 percentage points on 14 January following a 1-percentage point increase by the banks a week earlier. This action followed widespread charges that the government was indifferent to sterling's value. Although the move temporarily bolstered the pound, renewed weakness in oil prices later caused further downward pressure on the pound. Commercial banks responded by raising interest rates an additional 2 percentage points to 14 percent -- producing the highest real interest rates in 150 years, according to the Financial Times. Despite such high rates, the pound has since continued to decline and by 12 February touched an all-time low of \$1.087.

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The Bank of England also has intervened in the foreign exchange market by selling dollars. Such intervention has been limited, however, and has had little effect on the pound's decline. London bankers have told our Embassy they believe there is a growing split between the Treasury and the Bank of England over the question of intervention. The Bank appears to believe that more intervention is necessary but is under pressure by the Treasury to hold back.

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### Budget Consequences

The fall in the pound and the subsequent interest rate hikes will make it more difficult for the government to stay within its planned budget -- already under pressure because of increasing outlays for unemployment compensation and the effect of the coal strike on government borrowing. The depreciation of the pound has added at least 25 percent to the original estimated cost of the US-built Trident defense system and has forced the government to spread the cost over an additional five years. When Defense Secretary Heseltine announced in late January an upward revision in costs, he "updated" the pound-dollar rate to \$1.38 for the purchase of Trident missiles from the US. Critics were quick to point out that the pound stood well below the Defense Secretary's figure. More embarrassing for the government, according to reports of Parliamentary debates, defense officials were unable to provide detailed answers to possible future cost increases. Higher interest rates will also increase other government expenditures. The US Embassy in London estimates that debt service will rise this year by almost \$800 million if interest rates remain at their current levels for six months.

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Chancellor of the Exchequer Lawson added to Tory nervousness when he recently told Parliament he might have to abandon widely publicized plans to cut personal taxes by \$1.5-2.0 billion this spring. Even though Lawson has been counting on the tax cut to stimulate consumer spending, he has expressed concern about possibly reigniting inflationary pressures. Cancellation of the promised tax cut, however, almost certainly would fuel criticism of the government's tight fiscal policy.

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### Economic Consequences

Using our Linked Policy Impact Model (LPIM), we estimate that the fall in the pound from \$1.20 to \$1.12 would have had a negligible impact on GNP and unemployment in 1985, and a slightly beneficial economic impact in 1986 -- if the government had not raised interest rates (see Table 2). The immediate impact would have been mixed because the lower pound would have raised import prices, thus reducing real consumption spending, but also would have increased exports somewhat as British goods became more competitive. The longer run effect would have been clearly positive because over time British consumers have lowered spending on higher priced imports and increased spending on relatively lower priced domestically produced goods. Also, the competitive advantage reaped on the export side would have continued to boost sales abroad.

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London's efforts to halt sterling's decline by raising interest rates, however, will have a serious impact on the economy and could prevent 1985 economic growth from reaching the 3.1 percent widely forecast before sterling fell below \$1.20. We estimate that if interest rates are maintained at the

present level of 14 percent through 1986, GNP growth will be slower both this year and next due to sharply reduced growth of consumption and investment. A substantial improvement in the current account probably will be insufficient to offset these negative effects on GNP.

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### Political Impact of the Falling Pound

Apart from the economic problems resulting from the erosion of the pound, the potential political damage to Prime Minister Thatcher's credibility is considerable. We believe the Prime Minister sees the issue as one of confidence in her government's fundamental domestic and foreign policy approaches. Thatcher has also said that the value of a nation's currency reflects its basic strength, a notion her opponents are already using in attacks on the government. On 31 January, Thatcher and the Tories survived the strongest such attack by soundly defeating the Labor Party's motion of censure on the government's handling of the economy.

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Government efforts to support sterling, especially if required for a prolonged period, run against Thatcher's ideological convictions. In particular, such efforts undercut her philosophy that the government should not attempt to solve problems better left to market forces. Both Thatcher and Lawson, in answer to critics who demand greater public spending to alleviate unemployment, have claimed that market forces are ultimately the most effective means by which inefficient industries can be reformed and the economy lifted from its long malaise. Thatcher has also argued that, however painful in the short term, her policies are the only realistic way of dealing with long-term problems. The recent weakness of the pound is being portrayed by her opponents as a direct challenge to both notions. Yet failure to act could revive speculation that the government does not care how fast or far sterling drops, something that Thatcher has said is not the case.

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The plight of the pound also undercuts Thatcher's claim that she is leading Britain to a painfully achieved but lasting improvement in the economy. Pound crises, and subsequent interest rates hikes and budget cuts to "restore confidence," have been an all too familiar episode in post-war British history. The current situation could persuade voters who supported Thatcher in 1979 and 1983 that despite brave rhetoric, the country is on the same treadmill that the Tories promised to stop.

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### Prospects

Although the pound is almost back down to its 1975 level, we cannot rule out further depreciation. Should oil prices fall again -- which many oil experts expect to happen -- the pound is likely to continue its slide. In addition, heightened perceptions that monetary growth is too fast or that the government has abandoned its commitment to maintain sterling's value could lead to destabilizing speculative activity further depreciating the pound. Because the Prime Minister is on record that the pound should stay above parity with the dollar, she is caught in the position of making good a "commitment" entered into rather hurriedly.

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Thatcher probably will use her visit to Washington to press even more strongly for effective measures to contain the dollar's appreciation. She has often indicated that the solution to Britain's economic problems must come

domestically and she probably would like to solve the pound problem in the same fashion. She has complained, however, that part of the pound's problem is due to the "unprecedented" value of the dollar, which is beyond her control. Thatcher may remind the President of the agreement reached at the Williamsburg Summit and the G-5 meeting in January to intervene in the foreign exchange markets when necessary, and push for the US to intervene on a larger scale. She probably will ask for confirmation of Lawson's public statements that the US is willing under certain conditions to intervene in the market, and express a hope that threats of US intervention would close off a "one-way" street for speculation in US dollars. With the pound's depreciation pushing up the cost of the Trident program, she may also look for indications of additional US financial assistance in purchasing or maintenance of missiles in the future, particularly if dollar costs continue to escalate. [redacted]

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A prolonged "pound crisis" would threaten the very basis of the "Thatcher Revolution". Pressure on the pound is not new to the Thatcher government but the pound's recent fall has come at an inconvenient time, especially given expectations of tax cuts and renewed pressure on defense spending. The one bright spot for Thatcher is the fact that a new parliamentary election need not be called before June 1988. In the meantime the government's likely success in riding out the coal strike and the continued divisions with the opposition Labor Party serve to maintain the Prime Minister's overall standing in the country. Nonetheless, with the government's long-term defense strategy already being questioned and potentially controversial proposals to revamp the social welfare system likely to be unveiled this spring, Thatcher can ill afford a debilitating "crisis of confidence" over the pound. [redacted]

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Table 1. United Kingdom: Economic Indicators for the Thatcher Years

	1979	1980	1981	1982	1983	1984 Estimate <sup>a/</sup>	1985 <sup>a/</sup> Treasury Forecast	1985 <sup>b/</sup> Consensus Forecast
Real GDP (Percent Change)	2.7	-2.5	-1.5	2.5	3.2	2.5	3.5	3.1
Public Sector Borrowing Requirement (Percent of GDP) <sup>c/</sup>	4.9	5.7	3.4	3.3	3.25	2.5	2.0	2.1
Government Spending (Percent of GDP) <sup>c/</sup>	39.5	42.0	43.5	43.0	42.5	42.0	41.0	43.0
Money Supply (M <sub>3</sub> ) <sup>c/</sup> (Percent Change)	11.2	19.4	12.8	11.2	10.1	10.1	5.0-9.0	NA
Consumer Prices (Percent Change)	13.4	18.0	11.9	8.6	4.6	4.6	4.5	5.3
Unemployment Rate (Percent, end of period)	5.1	6.4	9.9	11.5	12.3	12.9	12.9	14.0

<sup>a/</sup>From the Treasury's autumn economic statement.<sup>b/</sup>Consensus of non-governmental forecasts issued in late 1984.<sup>c/</sup>Fiscal year basis.

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Table 2. United Kingdom: Economic Impact of a Weak Pound and High Interest Rates\*

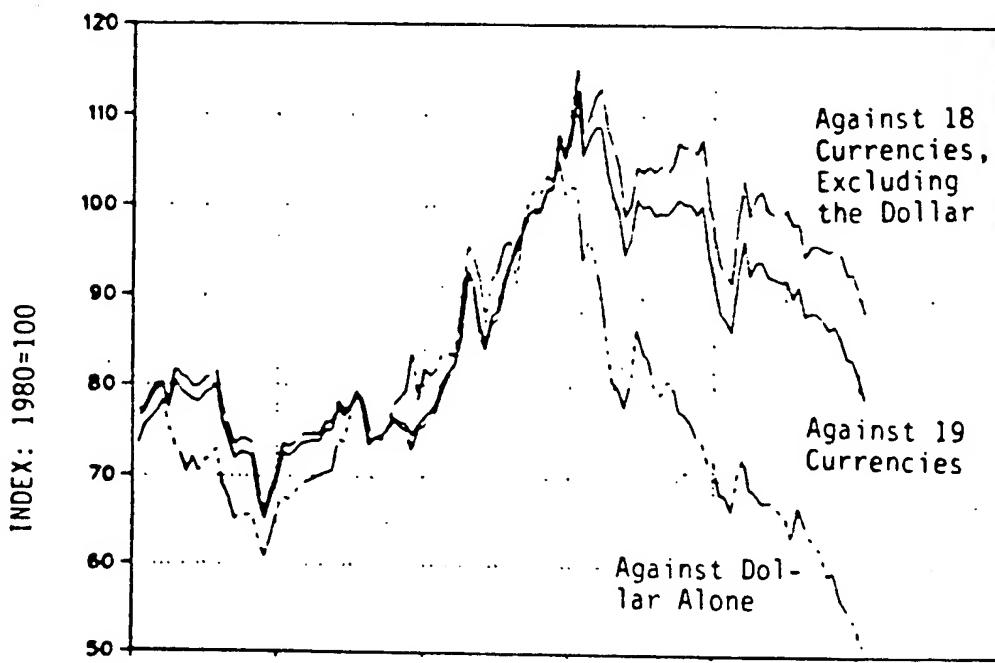
	Percentage point change from baseline scenario			
	Case I Weak Pound with Stable Interest Rates 1985 1986		Case II Weak Pound with Higher Interest Rates 1985 1986	
Real GNP Growth	-0.1	0.2	-0.6	-0.7
Of Which:				
Private Consumption	-1.8	-0.4	-2.9	-2.5
Government Consumption	-0.1	-2.4	0.3	-1.4
Investment	-0.6	0.1	-1.8	-2.1
Exports	0.9	1.2	0.8	1.0
Imports	-2.6	-1.6	-3.8	-3.7
Unemployment rate	0.0	-0.1	0.1	0.2
Inflation (Consumption Deflator)	1.8	1.1	1.6	0.8

\*Simulation results from CIA's Linked Policy Impact Model (LPIM). In the baseline scenario the pound and short-term interest rates are set at their late 1984 levels -- \$1.20 and 9.5 percent respectively. In case I the pound is lowered to \$1.12, with no change in interest rates. In Case II the pound is kept at \$1.12 while short term rates are raised to 14 percent.

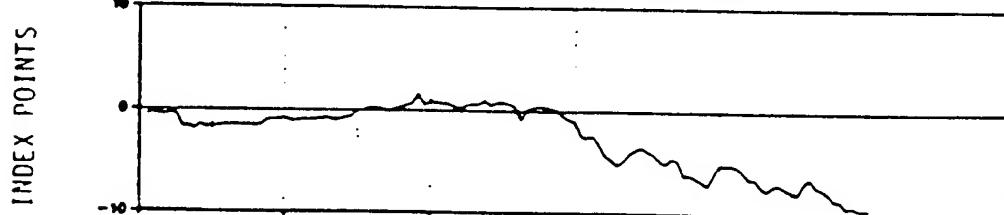
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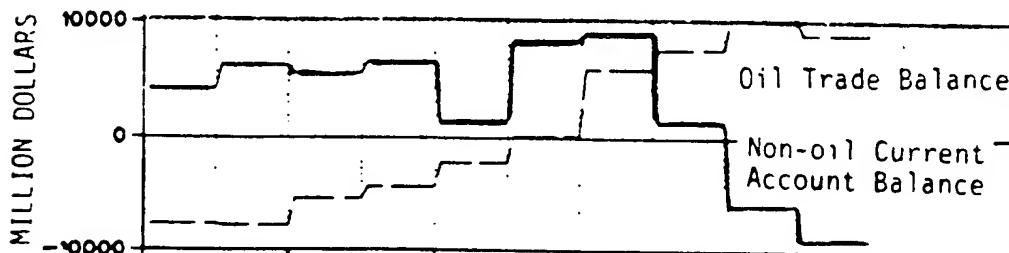
## UK TRADE-WEIGHTED PRICE-ADJUSTED EXCHANGE RATES



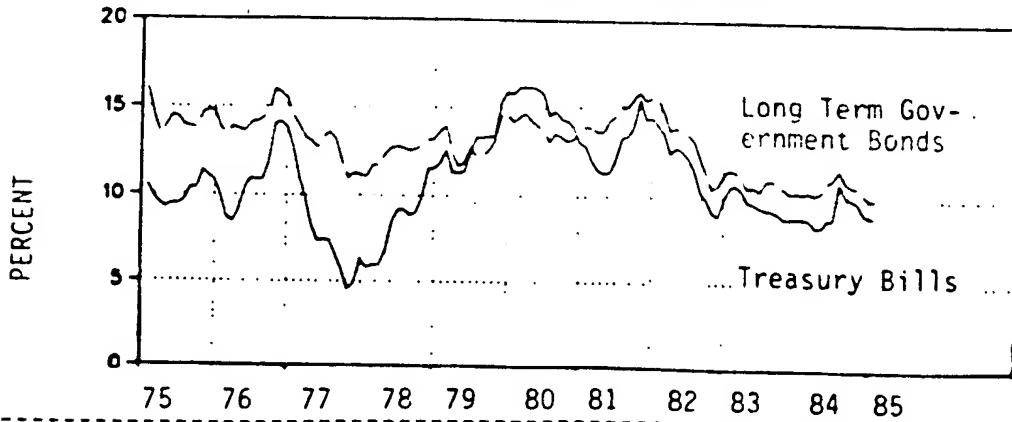
DOLLAR IMPACT ON UK TWXR 1/



## UK CURRENT ACCOUNT BALANCE



## UK INTEREST RATES



1/ The difference between the trade-weighted price-adjusted exchange rates, with and without the dollar, as shown in top figure.